

The challenges facing directors are often tied to the trading circumstances relevant to their business and the industries in which they operate. At a macro level, however, there are some challenges, not limited to depressed economic outlooks or capital market pressures, which impact directors and boards at all levels.

Those macro impacts often come to the fore when company stakeholders anticipate or experience reduced equities or trading losses. Consequently, impatient stakeholders sometimes look at forcing changes at boardroom level or, alternatively, pursuing their losses in the name of the company via derivative actions. Directors (and companies) should be actively managing those risks, particularly during challenging trading circumstances.

Leave to Proceed

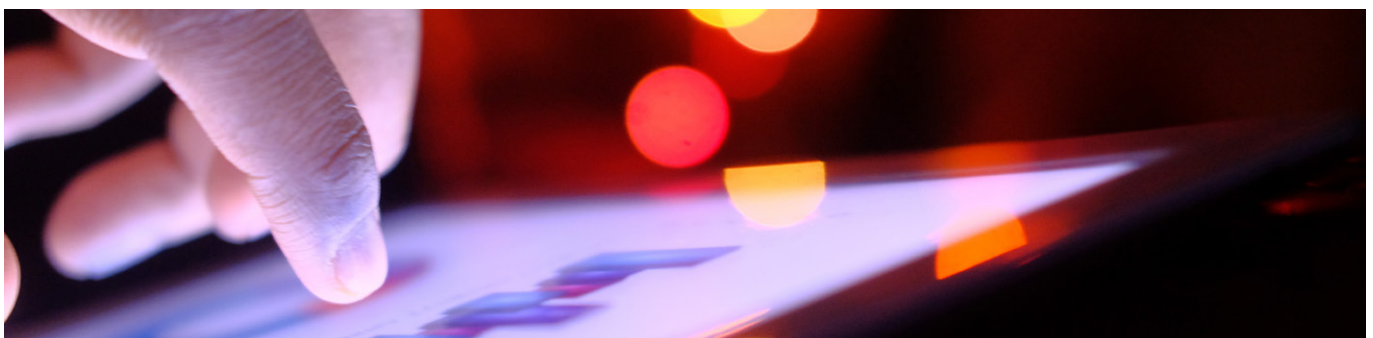
Bringing a derivative suit on behalf of a company is no walk in the park. Australia's Corporations Act (Act) and common law sets a relatively high bar to obtaining leave to proceed. Derivative litigants (and their benefactors) should closely examine the requirements under the Act and assess whether they have reasonable prospects of meeting the leave threshold before over-committing themselves. Similarly, those seeking to resist leave being granted – which may not be limited to directors – need to objectively consider the basis of their opposition. As part of that assessment, they should consider whether their opposition may, inadvertently, add to the strength of the arguments advanced in favour of leave.

A Complex Statutory Threshold

The Act requires the court to consider a number of factors before determining whether leave should be granted. Leave will only be granted if the court is satisfied, on the balance of probabilities, that:

- It is probable that the company will not itself bring the proceedings proposed, or properly take responsibility for them, or for the steps in them
- The applicant is acting in good faith
- It is in the best interests of the company that the applicant be granted leave
- If the applicant is applying for leave to bring proceedings, there is a serious question to be tried
- Either of the following:
 - At least 14 days before making the application, the applicant gave written notice to the company of the intention to apply for leave and of the reasons for applying
 - It is appropriate to grant leave even though subparagraph (i) is not satisfied¹

The question of standing is perhaps the most straightforward question to address in the context of a derivative suit. More often than not, the stakeholders proposing to litigate are shareholders and, therefore, qualify. However, recent authorities have opened the door to others obtaining leave, including creditors in external administration contexts.² The requirements under section 237(2) are cumulative and must all be met. If the court is satisfied, leave will be granted. However, if anyone one of the above matters is not satisfied, leave will be refused, and, in any event, leave is not granted lightly.³ Further, even if there is no active opposition, the court is required to undertake a thorough assessment of the statutory requirements before granting leave.



¹ See section 237 (2) of the Act.

² See, for example, *Re Barokes Pty Ltd (in liq)* [2022] VSC 642, 47 [116].

³ See *Swansson v RA Pratt Properties Pty Ltd* (2002) 42 ACSR 313 (Swansson).

Acting in Good Faith

A key component of the test under section 237(2) is whether the litigation proponent is acting in good faith. Assessing one's good faith is also a multidimensional exercise for the court. In a derivative suit context, the requirement that the applicant is acting in good faith has at least two elements. Firstly, the court must be satisfied that the applicant honestly believes the company has a sound claim with reasonable prospects of success. Secondly, it must be satisfied that the claim is not being brought for a collateral purpose such that it might amount to an abuse. The question of reasonable prospects cannot be addressed by mere assertion. A sound basis must be established to satisfy the court that the proposed litigation has discernible merit. The preparedness of a litigant to proffer indemnities for costs (including adverse costs) assists in demonstrating good faith and, conversely, any reluctance to do so would detract from leave being granted. However, some courts insist on litigation proponents putting their money where their mouth is and advancing actual monies or security for costs, as opposed to soft undertakings.⁴ The question of "purpose" can sometimes be difficult for courts to determine when the instructor on an application for leave is not cross-examined. In those circumstances, it would be safe to assume that the court would take a more considered approach and be acutely conscious of the authorities insisting that leave should be granted lightly.

Where there is already ongoing litigation, or threatened litigation, the mere assertion of good faith, in uncontradicted contexts, can mean that the court will exercise greater caution. While personal or commercial animosity towards other company stakeholders is not, of itself, demonstrative of bad faith, it would likely be cause for the court's concern.

The court has previously determined that:

"The question of good faith should be considered objectively. The fact that there is a serious question to be tried that the directors have committed breaches of their statutory and fiduciary duties is a major step in demonstrating objectively that the second plaintiff is proceeding in good faith."⁵

However, the assessment of good faith must be undertaken by reference to the factual basis underpinning the allegations advanced against directors (or other prospective defendants). Testing the prospects of success and its factual foundations is closely tied to testing the good faith requirements. Establishing a serious question to be tried in a derivative suit context is not a straightforward exercise.

It requires a significant degree of pre-action work being undertaken to (i) examine the factual, commercial and legal matrix, (ii) identify any causes of action or questions to be tried and, importantly, (iii) test the strength of the facts that underpin any claims, and the merits of the claims themselves.

The Company's Best Interests

In assessing whether to grant leave, the court must be satisfied that the proposed action actually is, on the balance of probabilities, in the relevant company's best interests. In order to prove that leave is in the best interests of the company, the applicant should generally give evidence of the character of the company, in the sense of the nature of the company's operations, so that the effects of the proposed litigation on the conduct of its business may be properly assessed by the court. Further, it should adduce evidence as to:

- Whether there are other means of obtaining the same redress so that the company does not have to be brought into litigation against its will
- The prospective defendants have the wherewithal to meet adverse judgment such that the court may ascertain whether the action would be of practical benefit to the company⁶

The Outlook for Directors

Although challenging trading circumstances often lead to more aggrieved company stakeholders and, ultimately, to greater or more hard-fought litigation, including derivative suits, all is not lost for directors. Provided that they can continue to discharge their legal and equitable duties, not limited to those under the Act, directors can take comfort out of the fact that the court will not simply green-light all applications for leave in derivative suits. Further, if directors can manage the competing interests of their stakeholders and ensure their decision-making processes at board level remain sound – and are appropriately revised in light of changed trading or legal circumstances – they will be well positioned to address any complaints (and claims).

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⁴ Ibid, at [36].

⁵ *McLachlan v Stephen de Vere* [2006] NSWSC 959 White J, at [53].

⁶ *Swansson* at [55]-[60].